No. 4043

IN THE 21

United States Circuit Court of Appeals

For the Ninth Circuit

In the Matter of MORRIS BROTHERS, INC.,
Bankrupt

ALBERT C. SMITH,
Appellant,

vs.

EARL C. BRONAUGH, Trustee in Bankruptcy of the Estate of MORRIS BROTHERS, INC., Bankrupt,
Appellee.

Appellee's Brief

Upon Appeal from the United States District Court for the District of Oregon.

I. N. SMITH, L. A. MCNARY and JOHN W. REYNOLDS,
Attorneys for Appellant.

J. P. WINTER,
Attorney for Appellee.

JOLLY-RATELLE, PRINTERS

LIST OF CASES CITED

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ALBERT C. SMITH,
Appellant,

vs.

EARL C. BRONAUGH, as Trustee in Bankruptcy of the Estate of MORRIS BROTHERS, INC., Bankrupt,
Appellee.

Brief of Appellee

Upon Appeal from the United States District Court for the District of Oregon.

STATEMENT

On the first of August, 1919, there was issued to Appellant by Morris Brothers, Incorporated, an interim certificate providing for the delivery of $2000.00, par value, of the preferred stock of Morris Brothers, Inc., or, in case of failure to deliver the preferred stock,

Morris Brothers, Inc., would pay to Appellant $2000.00 with interest thereon from August 1, 1919. The interim certificate so issued was as follows:

"MORRIS BROTHERS, INC.

INTERIM CERTIFICATE
No. 838

Portland, Oregon, August 1, 1919.

Upon the surrender of this certificate, properly endorsed, we will deliver to Mr. Albert C. Smith or order $2,000.00—Two Thousand and no/100 Dollars—6% Morris Brothers, Inc., Preferred Stock Bonds, due........optional..........19..., with..........and subsequent coupons attached, if when and as said bonds are issued and delivered to us.

In the event said bonds shall not be issued and delivered to us, we will redeem this certificate for Two Thousand and no/100 Dollars ($2,000.00), and the interest which would have accrued on the bond since August 1st, 1919, but such interest will cease thirty days after we transmit notice to the above named holder that the bonds will not be issued.

(Seal) By John L. Etheridge,
Treasurer."

At the time the interim certificate was issued, Appellant paid therefor by delivering to Morris Brothers, Inc., certain bonds which had matured. Morris Brothers collected the bonds, retained $2000.00 of the amount collected, and remitted the balance to Appellant.

When this interim certificate was issued to Appellant, Morris Brothers, Inc., was an Oregon corporation

with an authorized capital of $100,000.00 common stock only. It had no power to issue preferred stock. Thereafter, and about September 6, 1919, a new corporation was formed with a million dollar capital, consisting of $500,000.00 common stock and $500,000.00 preferred stock. Mrs. Stella M. Etheridge subscribed for all of the preferred stock and all of the common stock excepting a few shares. The old corporation transferred to this new corporation all of its assets and business in full payment of all the stock subscribed by Mrs. Etheridge, and thereupon the preferred and common stock was issued to Mrs. Etheridge. A portion of this stock which was issued to Mrs. Etheridge was surrendered by her to the corporation.

On July 13, 1920, a certificate of preferred stock of the new corporation which had been surrendered by Mrs. Etheridge was delivered to Appellant and his interim certificate was surrendered to the corporation. Dividends were paid on this preferred stock to Appellant from time to time until Morris Brothers was adjudicated bankrupt.

Although a going concern, Morris Brothers, Inc., was insolvent at the time Smith acquired the interim certificate, was insolvent at the time the preferred stock was delivered to Appellant, and continued insolvent thereafter until on December 27, 1920, it was adjudicated a bankrupt.

At the time of the adjudication Morris Brothers had assets of about $1,200,000.00 with liabilities aggregating over $2,000,000.00. Nearly all of these liabilities were contracted by the new corporation subsequent to the time Appellant paid his money to the old corporation.

The new corporation held itself out to the public as having a million dollar paid-up capital stock, and in dealing with the public collected nearly $2,000,000.00, for which the corporation issued interim certificates providing for the delivery of bonds. The record shows that the assets of the corporation will pay the general unsecured creditors thereof about fifty cents on the dollar.

The $2000.00 which Appellant paid for his interim certificate was used by Morris Brothers in its business and commingled with its other money.

Appellant makes no attempt to trace this $2000.00 either in its original or substituted form into the hands of the Trustee. The money was disbursed, likely dissipated, by the corporation in the transaction of business long before its was adjudicated a bankrupt.

ARGUMENT

Appellant contends, and for the purpose of this argument it will be assumed, that he was induced by misrepresentations to accept the interim certificate and pay for the same, or, in other words, that at the time Appellant contracted to buy the preferred stock he was deceived by misrepresentations made by the agent. Appellant makes two contentions:

1st—That the attempted sale of the preferred stock to him was void, and therefore he has a claim against the Trustee for the amount of money paid for the preferred stock on the theory of money had and received without any consideration;

2nd—That his claim is preferred to those of general creditors, and that he is entitled to a lien on certain bonds of the bankrupt to secure the repayment of this money.

Neither contention can be maintained.

For convenience, we will first consider Appellant's claim as an alleged preferred creditor. We submit that under the law there is no foundation for this claim whatever.

Appellant bases his claim as a preferred creditor upon the following allegations in the petition:

That the sums received by Morris Brothers corporation for preferred stock were carried in a distinct account upon the books of the company, both during the existence of the old corporation and the new corporation. That when the new corporation was organized and the preferred stock thereof was issued to Stella M. Etheridge, Stella M. Etheridge surrendered a part of her preferred stock which thereafter was issued to Appellant and other purchasers of preferred stock. That at the time this stock was surrendered, Stella M. Etheridge was given credit on the books of the corporation for the amount which had been received by the corporation for preferred stock sold, and thereafter that the corporation transferred to Stella M. Etheridge certain bonds of the par value of approximately $100,000.00, and to offset the credit given to her for the preferred stock surrendered charged her with these bonds.

The ledger and other books of account of the corporation were offered in evidence for the purpose of showing that the money which was received for preferred stock sold was kept in a distinct account, and for the purpose of showing that Stella M. Etheridge received credit for the par value of the preferred stock surrendered by her to the corporation, and for the purpose of showing that the corporation transferred to her bonds of the par value of over $100,000.00 in payment

for what the corporation owed her according to the books for the preferred stock surrendered by her to the corporation.

Immediately prior to the adjudication of bankruptcy, the bonds which had been delivered to Mrs. Etheridge were surrendered by Mr. Etheridge to Fred S. Morris as the property of the corporation. At that time Fred S. Morris was in charge of the affairs of the corporation.

The condition of the books of Morris Brothers was shown by Mr. Bosworth, an expert accountant in the employ of Whitcomb, Whitfield & Company, who made an audit of the books of Morris Brothers at the time of the adjudication. On cross-examination Mr. Bosworth testified as follows:

> "Q. Have you personally checked or examined all of the books and the different entries pertaining to the preferred stock that was issued by Morris Brothers?
>
> A. I have.
>
> Q. Will you state to the court the amount of preferred stock now outstanding.
>
> A. My recollection is outside of the amount to be owned by Stella M. Etheridge, $64,500 par value.
>
> Q. Can you refer to your books and give the court when that stock was paid for?
>
> A. The sale of preferred stock is evidenced by interim started November 1, 1918.
>
> Q. When was Mr. Smith's preferred stock paid for?
>
> A. He bought an interim for preferred stock July 31, 1919.

Q. Can you tell what he paid for it?

A. $2000.

Q. To whom was this paid?

A. The entry shows it was taken into the account of Morris Brothers.

Q. Do you know whether this money was used by Morris Brothers in the *general course of business?*

A. *It undoubtedly was.*

Q. From the examination of the books you have made?

MR. SMITH: We object to the question in the form in which it is put. We would have no objection to the witness attempting to show how the cash account treated it.

MR. WINTER: This is an expert witness.

Objection overruled.

A. The amount received from Mr. Smith went into the general funds of the corporation, and *used by them in their general operations.*

Q. What do you mean by general operations?

A. I mean *not segregated into a fund by itself* but went into the common fund and was probably deposited in the United States National Bank and used by them for buying bonds, stocks, paying wages, rent, etc. In other words it did not go into a trust fund, if that is what you are trying to get at.

Q. Will you turn to the entry of Mrs. Etheridge where she was given credit of $102,200 in the ledger; what is the date of that entry?

A. The heading of the account shows '1920' and the column that carries the day of the month shows '12.' There is no entry showing the month.

Other evidence though, from the journal, will show it was January 12th.

Q. January 12, 1920?

A. Yes.

Q. You may state whether this entry is true or fictitious?

A. It is apparently a fictitious entry.

Q. In what respect?

Mr. Reynold: We object to that.

Mr. Winter: We have a right to ask him about his report.

Mr. Reynolds: We object to the question and the answer and move it be stricken out for the reason it does not appear in what way the answer can apply, whether the fact is not true or whether the entry is a forgery.

Mr. Winter: Fictitious, not a forgery.

The Referee: If it is fictitious it is not a true entry, and you will have to inquire into that.

Q. Why do you state it is fictitious instead of being a true entry?

A. My reason may be for several reasons. In the first place my examination of the books does not show that anything was ever paid for the preferred stock by her. I find no record of any payment by her.

Q. Have you examined the records of Morris Brothers carefully to find out whether Mrs. Etheridge ever paid anything for this preferred stock?

A. I did in all places.

Q. And you discovered no such entry?

A. I discovered no such entry.

Q. At the time this preferred stock was issued to Stella M. Etheridge you may state whether or not Morris Brothers at that time was solvent or insolvent?

A. That is you want my expert opinion?

Q. Yes.

A. They were insolvent.

Q. They were insolvent at the time?

A. Yes.

Q. You may state if you can from your examination of the books whether or not you were able to ascertain whether Morris Brothers were insolvent on July 31st when Mr. Smith bought his preferred stock?

A. I would say they were insolvent at that time.

Q. You think they were?

A. I think they were.

Q. Did the corporation ever receive payment for the preferred stock issued to Mr. Smith except what was received from Mr. Smith?

A. Not that I ever found.

Q. If it had received payment would not you have discovered that fact in your examination of the books?

A. I would.

Q. What compensation, if any, did Morris Brothers receive for the check for $100,000.00 which was drawn on the U. S. National Bank and which was afterwards sent down to the bank at Forest Grove?

A. Nothing.

Q. From where was this $100,000.00 taken?

A. From the United States National Bank.

Q. Was that a deposit?

A. That was a portion of their deposit with the United States National Bank and withdrawn from that deposit.

Q. What compensation, if any, did Morris Brothers ever receive for any bonds that they apparently sold to Mrs. Etheridge?

A. None.

Q. No consideration was ever paid by Mrs. Etheridge for these bonds?

A. No true consideration. No consideration in the form of a valid payment. *Nothing but a book entry.*

Q. Then as to the books of Morris Brothers showing that Mrs. Etheridge purchased $100,000.00 worth of bonds, that is not true?

A. *The books show they were paid for but the entry is fictitious.*

Q. The fact is they were not paid for?

A. Yes, not by her.

Q. Were they paid for by anybody except by Morris Brothers when they bought them?

A. That is all.

Q. These bonds, according to the books that were sold to Mrs. Etheridge were the property of Morris Brothers?

A. Yes.

Q. And had been all paid for by Morris Brothers in the ordinary course of business?

A. Yes, that is right.

Q. And afterwards when they were turned over to Mrs. Etheridge Morris Brothers received nothing for them?

A. That is right."

(See Transcript, page 80.)

Mr. Bosworth's testimony clearly shows that the money received from Appellant for the preferred stock went into the general funds of the corporation and was dissipated by the corporation. It was not segregated or kept in a fund by itself.

The testimony further shows that Mrs. Etheridge never paid for the preferred stock that was issued to her; that when she surrendered it to the corporation she was not entitled to any credit, and when the bonds were delivered to her she did not pay any value for the same. Clearly, if Mr. Etheridge had not surrendered these bonds to the corporation the Trustee under the law could have recovered the bonds for the benefit of the general creditors of the corporation.

Under the facts as disclosed by this record, the Appellant would not be entitled to a preference even if he had proved that he paid his money to the corporation as trustee and thereafter the corporation had misappropriated the same. Even then to entitle the Appellant to a preferred claim it would have been incumbent upon him to trace the property either in its "original or substituted form" into the hands of the trustee. Upon this point the law is now well settled. Judge Rogers, in his opinion, given in *In Re See,* 209 Fed. 175, relating to the following of misappropriated property, quotes Professor Ames of Harvard University, and the subject seems to be so comprehensively covered by Pro-

fessor Ames that I am quoting the following from the decision of Judge Rogers, given in the "See" case:

"In an article on Following Missappropriated Property, which appeared in 19 Harvard Law Review 511 (1906), the particular question now under consideration was discussed by the late Prof. Ames. He said:

'In a few jurisdictions the true owner is given a preference over the general creditors of the wrongdoer upon the mere proof that the latter had the benefit of the misappropriated *res,* even though it is impossible to prove that the fund for distribution among the general creditors is, at the time of the preference allowed, larger than it would have been but for the misappropriation. But the allowance of a preference under such conditions is unjust to the general creditors. If the product of the true owner's *res* is still traceable in the assets of the wrongdoer, in the form of land, chattels, a bank deposit, or the money of a bank, its surrender to the true owner is eminently just. The creditors are left just where they would be if there had been no misappropriation. *If the true owner's res was used in paying one of the creditors, the true owner may fairly claim to be subrogated to that creditor's claim,* in which case, also, the dividends of the other creditors would not be affected by the misappropriation. *The same result is reached, if, without subrogation, the true owner is allowed to prove ratably with the other creditors.* But to go further and give the true owner a preference over all the general creditors means an unfair reduction of the dividend of the other creditors. If the true owner's *res* has been squandered, the dividend of the other creditors must be less because of the right of the true owner to prove his claim. But here, too, it would be gross injustice to pay the true owner in full, and thereby diminish still further the dividend

of the general creditors. The authorities are nearly unanimous against this unjust preference.' "

In the case of *Spokane County vs. First National Bank*, 16 C. C. A. 81, 68 Fed. 979, the Circuit Court of the Ninth Circuit laid down the following principle:

> "We are unable to assent to the proposition that because a trust fund has been used by the insolvent in the course of his business, the general creditors of the estate are by that amount benefited, and that therefore equitable considerations require that the owner of the trust fund be paid out of the estate to their postponement or exclusion. If the trust fund has been dissipated in the transaction of the business before insolvency, it will be impossible to demonstrate that the estate has been thereby increased or better prepared to meet the demand of creditors, and, even if it is proven that the trust fund has been but recently disbursed, and has been used to pay debts that otherwise would be claims against the estate, there would be manifest inequity in requiring that the money so paid out should be refunded out of the assets, for in so doing the general creditors whose demands remain unpaid are in effect contributing to the payment of the creditors whose demands have been extinguished by the trust fund. Both the settled principles of equity and the weight of authority sustain the view that the plaintiff's right to establish his trust and recover his fund must depend upon his ability to prove that his property is in its *original or a substituted form* in the hands of the defendant."

In the case of *Schuyler vs. Littlefield*, 232 U. S. 707, 58 Law Ed. 807, the Court had before it the question of whether a claim for a trust fund constituted a preferred claim, the appellants contending that even if the trust fund of about $10,000 was checked out of the bank, they were able to trace the fund into stocks that

subsequently came into the hands of the trustee in bankruptcy. This contention was based on the claim that out of the proceeds of the trust fund Brown & Co. had paid notes due to the bank and thereby released collateral which ultimately came into the possession of the trustee. In answering this contention, the Supreme Court said:

> "But the record fails to show when the $266,600 was deposited, and it also fails to show with the requisite certainty the particular use made by Brown & Company of that money. The banking transactions on August 24th involved several millions of dollars. Money was deposited by Brown & Company in the bank, and money was borrowed by Brown & Company from the bank. Part of the loans were deposited to the bank account, and a part represented by cashier's check did not appear in that account. Money was paid by Brown & Company to depositors and the bank. Payments to the bank were made on account of notes, some of which represented loans appearing in the deposit account, and others represented loans which had not been so entered. Some of the loans were secured and others were unsecured. And whether the money received from Miller, which included the trust fund of $9600, was used to pay the secured or unsecured loans does not appear with certainty. * * * Like all other persons similarly situated, they (appellants) were under the burden of proving their title. If they were unable to carry the burden of identifying the fund as representing the proceeds of their Interborough stock, their claim must fail. If their evidence left the matter of identification in doubt, the doubt must be resolved in favor of the trustee, who represents all of the creditors of Brown & Company, some of whom appear to have suffered in the same way. Like

them, the appellants must be remitted to the general fund."

Upon the point that the Appellant is not entitled to a preferred claim, we respectfully submit that the opinion of the trial court is unanswerable.

"The settled rule in this jurisdiction seems to be that claimant's right to establish his trust and recover his fund depends upon his ability to prove his property in its original or substituted form in the hands of the alleged trustee. *Spokane County vs. First National Bank of Spokane*, 68 Fed. 979, 982. This petitioner has been unable to do. All he can say is that the proceeds of his bonds have gone into the general business of Morris Bros., Inc. They have since probably been several times turned over. They have wholly and entirely lost their identity, either in the original or substituted character, and the claim is therefore not one that can be or ought to be preferred above those of the general creditors. To a like purpose, see *Schuyler vs. Littlefield,* Trustee of Brown & Co., 232 U. S. 707, and *In re See,* 209 Fed. 172.

It is strenuously insisted, however, that the bonds that found their way into the hands of Stella M. Etheridge in exchange for certain of the preferred stock of Morris Bros., Inc., and which were eventually found in Tacoma and returned to the company, constitute a segregated fund set apart and kept separate from the general property or assets of the company, and that therefore petitioner is entitled to a lien upon this fund. This contention overlooks entirely the principle upon which such a lien is predicated. These bonds that came into the hands of Stella M. Etheridge are by no means the same bonds, money or funds with which petitioner parted when he purchased the preferred stock. They were supposedly other bonds that

> Morris Bros. purchased or accumulated after petitioner parted with his Canadian bonds or money arising from the collection thereof, and were not that which constituted the consideration for the preferred stock that he acquired. It is not shown that the petitioner ever owned or acquired any interest in the bonds that were sold or set apart to Stella M. Etheridge, and I am aware of no principle applicable whereby he is entitled to a lien upon any of these particular bonds."

There is no proof in the record that the money which was paid by Appellant ever came into the hands of the Trustee either in its original or substituted form, and therefore there is no merit to the Appellant's claim to a preference.

We will next take up the point as to whether Appellant has a valid claim against the Trustee for the money paid for the preferred stock. As we view it, this question depends solely upon whether Appellant ever became a stockholder in Morris Brothers, Inc., for if Appellant became a stockholder in the bankrupt corporation, then his claim cannot be sustained against the Trustee for the obvious reason that a large amount of corporate indebtedness, over two million dollars, was created after Appellant became a stockholder.

The Appellant contends that he was induced by deceit to buy the stock, and that he never did become a stockholder of the corporation—not only that the agreement was voidable but that it was void.

We submit that the Appellant was a stockholder in the bankrupt corporation. He received the stock and owned it and held it until after the corporation was adjudicated bankrupt. He received and accepted dividends on this stock. The corporation had authority and

power to issue the stock, and if the corporation had prospered in business instead of failed, neither the corporation nor any stockholder of the corporation could have caused the cancellation of Appellant's stock or enjoined the payment of dividends to him. His subscription may have been voidable on the ground of fraud, but it was not void. Appellant is a stockholder in the bankrupt corporation.

The Trustee represents not only the corporation but the creditors of the bankrupt. In the case of *Falco vs. Kaupisch Creamery Co.,* 42 Ore. 442, the Supreme Court of this state holds that Section 70 of the Bankruptcy Act vests in the Trustee in Bankruptcy the right to recover unpaid stock subscriptions from the stockholders of an Oregon corporation.

The opinion in the Falco case is adhered to in the recent case of *Sargent vs. American Bank & Trust Co.,* 80 Ore. 16-27.

The court quotes from the Falco case with approval, as follows:

> "From this doctrine it necessarily follows that unpaid subscriptions to the capital stock of the corporation pass like other assets to the Trustee in Bankruptcy, and he is the only party that can bring an action or proceeding thereon."

Therefore in this state it is clearly the law that a Trustee represents the creditors of a bankrupt and has the power to enforce statutory liability. And in the construction of local statutes the decisions of state courts of last resorts will govern and control the federal courts.

See *Jackson vs. Chew,* 12 Wheaton 153.

In this state fraud is not a defense in an action by a

creditor of a corporation or a trustee of a bankrupt corporation to enforce stockholders' liability. In the recent case of *Morgan vs. Ruble,* 81 Ore. 641, the Supreme Court said:

> "There is but one question involved in this case and that is whether or not the fact that promoters of a corporation made false and fraudulent representations to the defendants to induce them to become stockholders can be relied upon to defeat the claim of a creditor."

The court in this case cites two decisions from Georgia and directly holds that as between a creditor and a stockholder of an insolvent corporation, fraud by the corporation in selling the stock is no defense.

For the same reason Appellant in this cause cannot base his claim upon false representations made at the time he bought the stock. The record in this cause shows that after Appellant had acquired his stock, the corporation held itself out to the public as having a million dollars of paid-up capital, and thereafter contracted large indebtedness. Claims amounting to over $1,800,000 have been filed with the Trustee. This vast indebtedness was contracted after Appellant had acquired his stock. (See Transcript, page 80.)

In the case of *Lantry vs. Wallace,* 97 Fed. 865, affirmed by the Supreme Court of the United States in 45 Law Ed. 1218, the Federal Court holds that where one was induced by fraud to purchase stock in a national bank, and continues to be a stockholder until after the bank becomes insolvent, he cannot set up the fraud as a defense in an action by the Receiver to recover the amount of an assessment on his stock "without showing *affirmatively* that there are no creditors of the bank who became such while he was a stockholder."

In *Newton Natl. Bank vs. Newbegin,* 74 Fed. Rep. 135, the Circuit Court of Appeals of the Eighth Circuit, speaking through Justice Thayer, says:

> "There are obvious reasons why a shareholder of a corporation should not be released from his subscription to purchase capital stock after the insolvency of the company, and particularly after a proceeding has been inaugurated to liquidate its affairs, unless the case is one in which the stockholder has exercised due diligence and in which no facts exist upon which corporate creditors can reasonably predicate an estoppel. When a corporation becomes bankrupt, the temptation to lay aside the garb of a stockholder on one pretense or another and to assume the role of a creditor is very strong, and all attempts of that kind should be viewed with suspicion. If a considerable period of time has elapsed since the subscription was made; if the subscriber has actively participated in the management of the affairs of the corporation; if there has been any want of diligence on the part of the stockholder either in discovering the alleged fraud or in taking steps to rescind when the fraud was discovered; *and, above all, if any considerable amount of corporate indebtedness has been created since the subscription was made which is outstanding and unpaid;* in all of these cases the right to rescind should be denied where the attempt is not made until the corporation became insolvent."

In the present case a year and a half expired from the time that Appellant purchased his stock to the time that the corporation failed, and all of the large indebtedness of the company now outstanding was created after Appellant obtained his interim certificate and even after his certificate of stock was delivered to him and the interim certificate was surrendered. Therefore, under the decision of the Court of Appeals the Appel-

lant cannot now void his subscription contract or rescind.

We therefore repeat that in this case Appellant's claim cannot rest upon misrepresentations, and that the sole question is whether the Appellant ever became a stockholder in the corporation, whether the preferred stock that was issued to him was void and a nullity.

When this cause was tried before the Referee, counsel for Appellant submitted numerous authorities to the effect that the stock subscription made by the Appellant was void because at that time Morris Brothers, Inc., had no authority or power under its articles to issue preferred stock.

But the point is not whether the agreement entered into by the Appellant to buy preferred stock is valid. The corporation afterwards did acquire the power and authority to issue preferred stock, and did issue the stock to the Appellant. It is conceded that a contract made by a corporation to sell stock which it has no authority to issue is not binding. It is conceded that where a corporation makes an over-issue of stock, that the stock so issued is not valid. But in the present case there was not an over-issue.

> "When a corporation which has already issued the full amount of its stock accepts a surrender of, or purchases the shares of one of the stockholders and afterwards re-issues the same, this does not constitute an over-issue."

Fletcher on Corporations, Vol. V, Sec. 3467.

In Thompson on Corporations, Vol. IV, Sec. 3545, the author says:

> "It is clear that the re-issue by the corporation of surrendered stock to another party does not constitute an over-issue of stock."

In the case of *Lantry vs. Wallace*, 45 L. Ed. 1218, a receiver brought an action against stockholders of a bank to enforce the stockholders' liability under the statute. The defense was made by one of the stockholders that he was induced by fraud to buy the stock, and that the purchase by him on account of the fraud was not simply voidable but was absolutely void, and that he did not by buying it or taking a certificate of stock become a shareholder within the meaning of the law, for the reason that the very stock which he had acquired was stock that had been illegally surrendered to the bank for cancellation. The Supreme Court in ruling on the point said:

> "It is true that the statute declares that no national bank shall be the purchaser or holder of any of its own shares of capital stock, but will a violation of this provision by the bank relieve from liability one who holds a certificate of its stock and enjoys the right of a shareholder?"

The Court concedes that the purchase of the stock by the bank was *ultra vires* and held that the bank in purchasing its own stock made unlawful use of its funds, but by selling the stock to the defendant the capital of the corporation was restored and the Court says:

> "We are at a loss to understand how this transaction on the part of the bank can operate to relieve the defendant from his liability as a stockholder in a suit brought by the receiver to recover a stock assessment which was levied solely for the benefit of corporate creditors. The sale of the stock to the defendant after the bank had purchased the same was not unlawful, since it operated to restore that part of the capital that had been retired and to that extent repaired the wrong which might otherwise have been done to the bank creditors."

So in the case at bar, even if the stock was irregularly issued to Mrs. Etheridge, or if the corporation had no right to purchase this stock, the sale of the same to Smith was not illegal and void.

The case of *Smoot vs. Perkins*, Texas Civil Court of Appeals, 195 S. W. 988, 40 Am. B. R. 193, is one in which the Court of Appeals of Texas put at rest this contention on the part of the plaintiff. In that case one Perkins and Kell had agreed to take five shares of the capital stock of the Northwestern Auto and Supply Company. They paid $250 in cash and executed their note for $250, payable to the corporation six months after date. The agreement was made before the corporation was organized. Afterwards the corporation was adjudged a bankrupt and Smoot as trustee brought action on the note. Perkins and Kell defended on two grounds—first, because the note was void, as it was given for stock issued in violation of the constitution and laws of the state of Texas, and, second, because they had been induced to take the stock by fraudulent and false representations of the president of the corporation. The trial court held that the note was void because given in violation of law in part payment for capital stock of the corporation. The evidence in the case showed that the defendant had taken no steps to repudiate the subscription before the appointment of the trustee in bankruptcy. The Court of Appeals held that upon these facts the trial court should have entered judgment for the plaintiff. The Court said:

> "Even if the stock had been issued, the appellee could not defeat a recovery of the note upon suit by the representative of the creditors of the corporation after it became insolvent."

Citing *McWhirter vs. First National Bank*, 182 S. W. 692, in which case a writ of error was denied by the Supreme Court of the United States. The court further held that the fraud, if it existed, would not under the facts in that case be a defense because the corporation became insolvent and the suit being by a representative of the creditors. Citing *Davis vs. Burns*, 175 S. W. 470, in which a writ of error was also denied by the Supreme Court, and numerous other cases.

In the instant case when Appellant paid his money to Morris Brothers, he did not enter into an agreement to buy preferred stock, but received an interim certificate by which the company agreed to deliver to him either preferred stock or pay to him a certain amount of money. Thereafter the stock was authorized and it was issued to the Appellant, received by him, and thereafter dividends paid to him and accepted by him. Can it now be said that the Appellant never became a stockholder in the company? If the company had been successful, could the holders of other shares of stock have enjoined the corporation from paying dividends on Appellant's stock?

Counsel for Appellant has cited no authority, and we believe none exists, to the effect that the preferred stock issued to the Appellant is a nullity, or to the effect that the Appellant is not a stockholder in the company.

At the time Appellant paid his money and received the interim certificate, he was bound to know that under its charter Morris Brothers had no authority to issue preferred stock. Persons dealing with a corporation or with the managers of a corporation must take notice of the limitations imposed upon their authority by the act of incorporation. The law secured to the Appellant

the means of ascertaining the real capital of the company. Appellant was bound to know that at the time he acquired the interim certificate Morris Brothers, Inc., under the law was not authorized to issue preferred stock.

> *Scoville vs. Thayer,* 105 U. S. 143-147, 26 L. Ed. 971, 972.

In that case the Supreme Court of the United States had before it the question as to whether the holder of unauthorized stock in a corporation was entitled to have money paid thereon by him applied as a credit on the unpaid balance due on the authorized stock held by him. The Supreme Court in denying this right to a set-off said:

> "It (referring to the payment made on the unauthorized stock) was a voluntary payment for the benefit of the company and tended to increase the value of the authorized stock. In that way the stockholders got the benefit of it. *There is no rule of law or equity which entitles him in a contest between himself and a creditor of the company either to receive a credit for it on his unpaid stock, or to have it repaid to him pro rata out of the assets of the company.*"

This was an action brought by assignees in bankruptcy to collect for unpaid stock subscriptions.

Upon the argument of this cause counsel for Appellant submitted a supplemental brief in which the contention is made that the Appellant had undertaken to buy stock in the "original Morris Brothers, Inc.," and thereafter there was delivered to him stock in a new corporation; that the Appellant thought he was dealing with the old corporation, never intended to accept stock in a different corporation, and therefore he never be-

came a stockholder in the reorganized company. To sustain this proposition, the familiar rule is stated to the effect that "there is no agreement where one party enters into a contract under a mistake as to the identity of the other party, as where the party contracted with has falsely represented himself to be another, or has accepted an offer meant for another." This principle of law has no bearing upon the instant case.

In the first place, Appellant was bound to know under the law that the "original" corporation had no power to issue preferred stock. As stated by the Supreme Court in the case of *Scoville vs. Thayer, supra,* the Appellant was as much bound to know the limits of the charter of the company in which he was to become a stockholder as the public or creditors of the company. Therefore, he knew that the old corporation had no power to issue preferred stock. The law is well settled that all persons subscribing for stock in a corporation are presumed to know the provisions of its articles of incorporation and their effect, and if they are induced to subscribe by false representations of the agents of the corporation as to the powers of the corporation, or that it will do what its articles do not authorize it to do, they cannot rely upon such representations as grounds for rescinding the subscription. This is true, for instance, of false representations that a railroad company has a right to or intends to construct its road along a certain route, and similar representations where its route or termini are fixed by its charter.

> *Upton vs. Tribilcock,* 91 U. S. 45, 23 L. Ed. 203.
> *Parker vs. Thomas,* 19 Ind. 213, 81 Am. Dec. 385.

Therefore, at the time that the Appellant received his interim certificate for the preferred stock or the pay-

ment to him of a certain sum of money, he was bound to know, or conclusively presumed to know, that Morris Brothers, Inc., had no power to issue preferred stock; that they did not have $500,000 worth of common stock issued and paid.

As a matter of fact, Mr. DeLong, a witness on part of Appellant, testified on cross-examination as follows:

"Q. Now just repeat the conversation you had with Mr. Smith.

A. Well, as I said, I cannot repeat the words that I used.

Q. Repeat the substance of it then.

A. I approached him and told him that the company was reorganizing, that they were expanding and increasing their business inasmuch as they expected to have additional capital.

Q. In regard to that you had personal knowledge of the company and knew that they were increasing their business and their stock?

A. Yes.

Q. You knew that personally?

A. Yes.

Q. You knew that to be a fact?

A. Yes.

Q. What else did you tell him?

A. I told him—I went into details with this preferred stock, told him there would be so much issued, and so on.

Q. Did you tell him how much would be issued?

A. I must have told him how much would be issued.

Q. What did you tell him in regard to that?

A. As to how much would be issued?

Q. Yes.

A. It was about the time that I learned of the million dollar corporation and I think I told him about that.

Q. Did you tell him how much preferred stock was sold?

A. Well, I don't know whether I did or not.

Q. How much was sold; did you know how much had been sold at that time?

A. At that time there had been something over $80,000 worth sold, maybe more.

Q. Did you tell Mr. Smith that you had sold $80,000?

A. Now I must have told him. I would think that I did tell him.

Q. You now remember that you expected to sell about $420,000 more?

A. No, I did not.

Q. You told him they expected to sell about half a million dollars worth of preferred stock?

A. That was the issue.

Q. You said you had sold about $80,000 at that time, at the time he subscribed?

A. Yes."

(See Transcript, page 75.)

According to this testimony the Appellant was told that the company was to be reorganized, that the pre-

ferred stock was to be issued, and that he was buying a part of this preferred stock.

Counsel for Appellant cite the case of *Campbell vs. Coin Machine Co.,* 96 Ore. 119, as in point. In that case plaintiff had agreed to buy stock in a corporation with a capital stock of $4,000,000, divided into 40,000 shares of the par value of $100 each, and paid upon his subscription $375. Thereafter, without the plaintiff's consent, defendant corporation reduced its capital stock from $4,000,000 to $400,000, consisting of 40,000 shares of the par value of $10 per share. The Supreme Court in deciding the case said:

> "The plaintiff contracted to invest $500 in a corporation with a capital stock of $4,000,000, or to furnish one eight-thousandth part of the capital. The defendant proposed to the plaintiff that he shall invest $500 in a corporation with a capital stock of $400,000, or to furnish one eight-hundredth part of the capital."

The Court held the decrease in the capital stock and the amount of capitalization admitted to have been made by the defendant company without plaintiff's consent changed the corporation from a strong concern with a capital of $4,000,000, or at least one-half thereof if only half of the stock was subscribed, to a smaller and weaker one with only one-tenth as much capital, and that plaintiff therefore was not bound to take stock in the changed corporation.

In the case at bar the Appellant knew that the old Morris Brothers corporation did not have $500,000 worth of common stock, and had no power to issue any preferred stock. He was told that a reorganization was taking place, and that $500,000 worth of preferred stock

would issue. Appellant therefore knew that the old corporation could not issue this stock to him, and that he would receive it out of a corporation that was reorganized, or a new corporation.

Under the law the Appellant was conclusively presumed to know that when the preferred stock was delivered to him and accepted by him that the new corporation had been formed; he was bound to know the provisions of its articles; he was bound to know that he was receiving stock in this new organization because it was the only organization that had power to issue it. With this knowledge he received the stock and retained it and accepted dividends on it. Can he now claim that he was not a stockholder in the new corporation, that his stock certificate was a nullity and that his claim is on a par with that of the general creditors of the corporation?

We do not deem that it is necessary to consider to what extent a purchasing corporation is bound to pay the debts of a selling corporation, or whether the new corporation was a mere continuance of the old, or whether there was an implied agreement that the new corporation should assume all of the debts of the old.

Appellant is a stockholder in the bankrupt corporation, and therefore as between the Appellant and the trustee in bankruptcy who represents the creditors of the corporation, claimant cannot prevail.

It is elementary law that a stockholder of a corporation is not entitled to any of its assets until the creditors have been paid in full. The public dealt with the bankrupt and trusted the corporation, relying upon the fact

either that its capital stock had been paid for or was due from the stockholders. This the court presumes.

> *Randal Printing Co. vs. Sanitas Mineral Water Co.,* 120 Minn. 268, 43 L. R. A. (N. S.) 706.

The Appellant is a stockholder in the company, and as such his rights are inferior to those of a creditor of the company, and therefore the petition must be denied.

Respectfully submitted,

J. P. WINTER,

Attorney for Trustee.